80-1109

No.

Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1980

BERNARD E. TEICHGRAEBER; ESTATE OF BARBARA G. TEICHGRAEBER, DECEASED, BERNARD E. TEICHGRAEBER AND RICHARD F. TEICHGRAEBER, EXECUTORS; BERNARD E. TEICHGRAEBER AND ESTATE OF BARBARA G. TEICHGRAEBER, DECEASED, BERNARD E. TEICHGRAEBER AND RICHARD F. TEICHGRAEBER, EXECUTORS; RICHARD F. TEICHGRAEBER AND WINIFRED M. TEICHGRAEBER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented for Review

1. Whether a partner who has withdrawn from a partnership is taxable upon a share of partnership income retroactively created by the Commissioner after the partner's withdrawal, despite the undisputed absence to the withdrawing partner of any accession to his wealth or any other actual or constructive gain to him from such retroactively created income.

2. Whether such retroactively created income may be taxed to such withdrawn partner in the face of a special allocation in the partnership agreement expressly allocating such income in its entirety to the remaining partners of the partnership and expressly precluding such partner from sharing therein to any extent.

3. Whether, if such withdrawn partner is required to include such amounts in income, he is also entitled to a correlative ordinary loss deduction to reflect the economic detriment attributable to his inability to secure the retroactively created income upon which he is being taxed and to reflect the ~~deferring~~ DEFICIENCY in the payment he received upon his withdrawal from the partnership.

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Petitioners,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioners, Bernard E. Teichgraeber; Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, executors; Bernard E. Teichgraeber and Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, executors; Richard F. Teichgraeber and Winifred

M. Teichgraeber (collectively, the "Taxpayers") respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding, Docket No. 80-4053.

Opinions, Judgments and Orders Below

The Memorandum Findings of Fact and Opinion of the United States Tax Court, filed December 13, 1979 (as amended by Order of the Tax Court filed December 14, 1979), attached in the Appendix as Exhibit A, which upheld the determination of the respondent (the "Commissioner") of Federal income tax deficiencies and additions to tax on the part of each of the petitioners, was designated Tax Court Memorandum 1979-500 and is unofficially reported as CCH Dec. 36,494(M) at 39 T.C.M. 710. The Court of Appeals issued no formal opinion in affirming the decision of the Tax Court.

The Decision of the Tax Court, entered December 20, 1979, appears in Exhibit B of the Appendix hereto. The judgment of the Court of Appeals, filed October 7, 1980, is included in the Appendix as Exhibit C.

Jurisdiction

This petition for certiorari is being filed within 90 days of October 7, 1980, the date on which the judgment of the Court of Appeals was filed. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Constitutional, Statutory and Regulatory Provisions Involved [1]

(a) The provisions of the United States Constitution involved herein are Amendment V, requiring due process for the taking of property, and Amendment XVI, permitting Congress to levy and collect taxes on "income".

(b)(1) The Federal statutory provisions involved herein are Sections 704(a) and 704(b) of the Internal Revenue Code of 1954 (26 U.S.C. §§704(a), 704(b)), which provide, in general, that during the taxable year in question, a partner's distributive share of income and loss is determined by the partnership agreement, including any special allocation of items having substantial effect set forth in the partnership agreement.[2]

(2) The New York State statutory provisions involved herein are New York Civil Practice Law and Rules Section 213(2), providing a six-year statute of limitations for commencement of an action upon a contractual obligation, and Section 7501, providing, in general, for the nonjusticiability of controversies subject to an arbitration agreement.

(c) The regulatory provisions involved herein are Treas. Reg. §1.704-1(b)(2), and Example (4) thereafter, relating to the determination of the distributive share of a partner in accordance with the terms of the partnership agreement.

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1. The pertinent texts of the constitutional, statutory and regulatory provisions involved herein appear in the Appendix as Exhibit D.

2. Section 213(e) of the Tax Reform Act of 1976, P.L. 94-455 (94th Cong., 2d Sess. (1976)) amended Section 704(b) in a manner not relevant here; Section 213(e) is reproduced in Exhibit D of the Appendix.

Statement of the Case

(a) Basis for Federal Jurisdiction

The Taxpayers timely commenced this action in the Tax Court by filing petitions for a redetermination of the deficiencies in Federal income tax alleged to exist on their part by the Commissioner, in accordance with Section 6213 of the Code, 26 U.S.C. §6213.

(b) Background

The sole issue involved in this case is whether two general partners and a limited partner who withdrew from a partnership in 1966 and 1967, and who, pursuant to an arbitration proceeding in the case of one partner and arms'-length negotiated settlements in the case of the other two partners, were paid in liquidation of their respective partnership interests amounts which could never thereafter be increased, may be taxed on income retroactively created by the Commissioner upon his agreement with the partnership several years thereafter. This agreement disallowed certain partnership deductions for its taxable years ended December 31, 1966 and 1967 and instead allowed a portion of such deductions to the partnership in its succeeding taxable year, 1968, by which time all three taxpayers had withdrawn from the partnership and were therefore not entitled to the benefit of such deductions.[3]

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3. The "rollover" of these deductions to 1968 produced substantial economic benefit to all of the remaining partners (i.e., all of the 1967 partners other than the taxpayers) since there was an income tax surtax in effect in 1968 and the profits of the partnership were higher in 1968 than in either 1967 or 1966. Thus, the deductions were more valuable to the remaining partners in 1968.

The withdrawing partners in this case had no entitlement to the income retroactively created by the Commissioner, either under the express terms of the partnership agreement or under local law. Under the explicit terms of the partnership agreement, the capital account of a withdrawing partner was only entitled to share in those profits economically realized by the partnership prior to the date of his withdrawal from the partnership and conversely, was charged only with losses economically realized by the partnership prior to that date, regardless of whether these profits and losses correlated in any sense with the tax law definition of income or deduction. Any profits and losses economically realized after a partner's withdrawal could not be credited or charged to that partner.

As applied to the facts of this case, the capital accounts of the three taxpayers, as withdrawing partners, were charged with their proportionate shares of the expenses and losses economically incurred by the partnership, up through the date of withdrawal of each partner, and passed along to its partners at that time. The fact that these economic costs might be subsequently deemed nondeductible in those years was wholly immaterial to the withdrawing partners; their capital accounts were frozen as of the date of their withdrawal and nothing further could be, or ever was, allocable to them, under the intended method of operation of the partnership agreement.

Subsequent to the date of withdrawal of the three taxpayers and the computation of the amount due to each, one of the three partners resorted to arbitration with the part-

nership over the amount he was entitled to receive from the partnership in settlement of his account.[4] After he had exercised his full legal rights by having the issue arbitrated, the arbitration panel declared him entitled to a fixed amount, which took into account his aliquot share of economically accrued partnership losses through his date of withdrawal. In its decision, the panel stated that such amount was "in full and final settlement" of all of his rights against the partnership, thereby precluding him from ever obtaining any future adjustment from the partnership with respect to partnership profits or income, or ever successfully suing the partnership with respect thereto.

(c) Basis of this Action

Some five years following the withdrawal of the three petitioner-taxpayers from the partnership and the payments to them of the value of their interests in the partnership, the partnership information returns filed for its taxable years ended December 31, 1966 and 1967 were audited by the Commissioner. The partnership agreed to the disallowance of amounts deducted in those years relating to bad debts, interest costs, travel and entertainment expenses, and, for 1967 only, "conversion error losses", losses that had arisen through the misdirection of certain receipts and disbursements of the partnership upon the conversion of the partnership's in-house recordkeeping system to a computerized system.

4. Under the rules of the New York Stock Exchange, to which the partnership belonged, any controversy between the partnership and a partner with respect to the business of the partnership was subject to binding arbitration and accordingly, under local law, was nonjusticiable.

The conversion error losses represent the great bulk of the items in dispute.[5] Significantly, though, no question was raised by the Commisisoner as to the amount of the conversion error losses or as to their having been economically sustained by the partnership in calendar year 1967; only the timing of the deduction of these losses for Federal income tax purposes was at issue.

The partnership agreed to the disallowance of the conversion error losses in 1967 in return for the full allowance of such losses as a deduction for its 1968 year, a period following the withdrawal of the three petitioner-taxpayers. The "rollover" of this deduction resulted in a substantial tax benefit to the remaining members of the partnership, because partnership income reported for calendar year 1968 was approximately $1,600,000 greater than its income reported for calendar year 1967, and because a 7½% surtax was imposed against 1968 income, but not against 1967 income.

The partnership negotiated the terms of this compromise, without the knowledge or participation of the petitioners. The Commissioner took the position that they were not entitled to enter into the proposed closing agreement with the partnership since they had not been partners in 1968, and accordingly, were not entitled to any share of the deduction created against 1968 partnership income by the rollover of the conversion error loss from 1967 to 1968. On the other hand, the Commissioner sought to tax the peti-

5. The conversion error losses aggregated $1,343,740, and all other deductions in dispute aggregated $633,247 and $228,623 for the taxable years of the partnership ended December 31, 1966 and 1967 respectively.

tioners on income allegedly attributable to their partnership interests, which had terminated in 1967, resulting from the rollover of the 1967 deduction into 1968 and the disallowance of the 1967 deductions.

In seeking to tax the petitioner-taxpayers on such retroactively created "income", the Commissioner disregarded the fact that the partnership did not adjust their distributive shares, or otherwise afford them any benefit, credit, payment or income, to account for the adjustments upon which the Commissioner was asserting a tax. Nor could the petitioners have compelled any such adjustment, because as a result of the arbitration award in one's case and the arms'-length negotiation and settlement of the other's accounts, they had no legal right against the partnership to have their liquidation payments increased or any payments made to them by the partnership as a result of the adjustments occurring after their withdrawal from the partnership.[6] Instead, pursuant to the terms of the partnership agreement, all such amounts were allocable to the other partners of the partnership. Nevertheless, in 1967 they had unquestionably sustained the economic detriment of the losses and expenses ultimately agreed to be nondeductible in 1966 and 1967 and deductible in 1968, because the payments made to them in liquidation of their partnership interests had been decreased to reflect such losses and expenses.

6. While for tax purposes, these adjustments allegedly represented "income", insofar as the withdrawn partners were concerned it was illusory. Since they could never obtain any such amount or derive any conceivable benefit from such "income" which the respondent taxed, it did not represent any gain, but rather an unexpected and overwhelmingly large economic detriment.

(d) The Decisions Below

The Tax Court held that, in this situation, the petitioners were taxable upon a share of the partnership income retroactively created by the Commissioner after their withdrawal from the partnership, notwithstanding that each such partner had been charged upon his withdrawal from the partnership with the economic loss attributable to the major portion of such deductions, and notwithstanding that under the terms of the partnership agreement gains or losses realized after a partner's withdrawal were allocated in their entirety to the remaining partners of the partnership, and despite the undisputed absence to the withdrawing partners of any accession to their wealth or any other actual or constructive gain to them from such retroactively created income.

Thus, the Tax Court upheld the imposition of tax on "income" a withdrawing partner would never realize but yet denied him the benefit of deducting a loss he had economically sustained. At the trial of this matter, after these facts relating to the withdrawing partners' predicament had been elicited, the trial judge suggested that the result was "hard" and "mechanistic", and counsel for the Commissioner admitted that the result for which he was contending was in fact a "harsh" one.

Subsequently, the Court of Appeals affirmed the decision of the Tax Court, without opinion, in a one sentence decision.

Reasons for Granting the Writ

The decisions below violate the well-established constitutional precept that in order for there to be "income" taxable under the Sixteenth Amendment, there must be pecuniary gain or some other undeniable accession to wealth, and violate the Fifth Amendment requirements of due process. The decisions below are contrary to decisions of this Court, as well as the Internal Revenue Code, the Income Tax Regulations, and published revenue rulings, and inflict a gross injustice upon the petitioners.

By reason of the lack of entitlement of the withdrawing partners to any portion of the income retroactively created by the Commissioner, and in the absence of any benefit whatsoever to be derived therefrom, no one of the three petitioners should be taxed on any such income. Rather, such income, which under the terms of the partnership agreement is properly allocable to the remaining partners, should have been taxed, if at all, to them. In the alternative, if the withdrawing partners are required to include such amounts in income, they are also entitled to a correlative ordinary loss deduction to reflect the deficiency in the payment they received when they withdrew from the partnership and the economic detriment they will have sustained by their inability to secure the income upon which they would have been taxed.

POINT I

The Income Created by the Commissioner Must Be Excluded from the Taxpayers' Gross Income.

A. The Taxpayers May Not Be Taxed on Income They Did Not Receive and Are Prohibited from Receiving.

It is indisputable that the petitioners, as withdrawing partners, never received, and never could have received, any economic benefit whatsoever from the partnership after their withdrawal except payments in liquidation of their capital accounts, which were frozen as of the date of their withdrawal. Thus, they never received, actually or constructively, nor derived any economic benefit from, the retroactively created "income" which the Commissioner seeks to tax to the petitioners.

As a matter of State law, the Taxpayers never had any remedy available to them with respect to the shortfall on which the Commissioner is imposing tax. By mid-May 1973, when the Taxpayers were first apprised of the Commissioner's attempt to tax them on these retroactively created sums of income, the applicable statute of limitations had lapsed with respect to any claim by two of the three withdrawn partners against the partnership. These two partners had both withdrawn from the partnership more than six years prior to mid-May 1973 (one on April 27, 1967 and the other at her death on October 14, 1966), and thus the six-year statute of limitations provided by Section

213(2), New York Civil Practice Law and Rules, relating to an action on a contract, had run.[7]

Thus, if the Taxpayers' "remedy" was to sue the partnership, it was one which could not be utilized; realistically, the combined effect of the statute of limitations, and the express terms of the partnership agreement denying any such income to withdrawing partners, served to render a lawsuit or an arbitration proceeding against the partnership a futile endeavor at the time the Commissioner created the "income" in question.

Under like circumstances, this Court turned back an attempt by the Commissioner to tax a party on amounts inaccessible to him and from which he could derive no benefit whatsoever. In *Comm'r* v. *First Security Bank of Utah,* 405 U.S. 394 (1972), *aff'g* 436 F.2d 1192 (10th Cir. 1971), this Court unequivocally rejected an attempt by the Commissioner to tax to a bank a portion of the insurance premiums received by a related life insurance company, when the bank was not legally entitled to receive insurance-related income. This Court stated:

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did

7. While the third withdrawing partner remained a partner until December 31, 1967, after notice of the closing agreement and rollover was conveyed to him, he hardly had an opportunity in the few months remaining until the statute lapsed to analyze the complex facts of this matter and to deliberate and determine if he was required to immediately bring an action against the partnership. Furthermore, in December 1972, this petitioner had suffered a seriously disabling stroke and was unable to effectively communicate with third parties. In any event, even if he had sought to bring such a suit or such a suit had been brought on his behalf, his position would be contrary to the partnership agreement and doomed to failure because of that.

> not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.' *Corliss* v. *Bowers,* 281 U.S. 376, 378 (1930)." (405 U.S. at 403)

This Court's holding in the *First Security Bank* case reflects the fundamental and well-established principle of Federal income tax law that precludes a person from being taxed on amounts he neither (actually or constructively) receives nor has the right to receive. In this respect, this Court cited with approval *Teschner* v. *Comm'r,* 38 T.C. 1003 (1962), where the Tax Court said:

> "Petitioners contend that the value of the annuity policy should not be included in their gross income *because they did not receive anything either actually or constructively and never had a right, at any time, to receive anything that could have been the subject of an anticipatory assignment or similar arrangement.*
>
> "We agree with the petitioners." (38 T.C. at 1006) (Emphasis added).[8]

In short, where a taxpayer may not actually or constructively receive income or derive any benefits therefrom,

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8. Even the dissenting Justices in *First Security Bank* accepted the holding in *Teschner,* noting: "This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter. See e.g. *Blair* v. *Commissioner,* 300 U.S. 5 (1937); cf. *Teschner* v. *Commissioner,* 38 T.C. 1003 (1962)." (405 U.S. at 410).

the tax law does not countenance the taxation of such income. Under this principle, the Taxpayers, who unquestionably had no right to income realized after the three withdrawing partners had withdrawn from the partnership, may not be subjected to a tax on such income.

B. The Result Urged by the Commissioner Violates the Fifth Amendment and Sixteenth Amendment to the United States Constitution.

Judge, now Justice, Blackmun has noted that "[t]axation is an intensely practical matter and laws in respect of it should be construed and applied with an aim to avoid, so far as possible, unjust and oppressive consequences." *Cherry-Burrell Corp.* v. *United States,* 367 F.2d 669, 674 (8th Cir. 1966), quoting *Farmers' Loan & Trust Co.* v. *Minnesota,* 280 U.S. 204, 212 (1930); *Tyler* v. *United States,* 281 U.S. 487, 503 (1930). To tax the petitioners on a retroactive basis upon income which they can never realize and from which they will never derive a benefit would produce "unjust and oppressive consequences", of a type which this Court has held "so arbitrary and oppressive as to be a denial of due process." *Welch* v. *Henry,* 305 U.S. 134, 146 (1938).

While the Sixteenth Amendment entitles Congress "to lay and collect taxes on income", this Court has repeatedly held that before the Sixteenth Amendment may apply to a given case, in order for there to be "income" to be taxed, there must be pecuniary gain with "realizable economic value." *James* v. *United States,* 366 U.S. 213, 219 (1960). For this reason, the classic definition of income taxable under the Sixteenth Amendment requires "undeniable

accession to wealth, clearly realized and over which the taxpayers have complete dominion". *Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

Here, the Taxpayers never received, or could have received, any economic benefit, either actual or constructive, or any other accession to their wealth, from the "income" sought to be taxed to them in this case. Thus, to impose a tax upon gain which is purely an illusion to the petitioners and results in no conceivable accession to their wealth, is violative of the Fifth and Sixteenth Amendments to the Constitution.

In numerous instances in the past, the courts have excluded from income, not only amounts which a taxpayer was barred from receiving, which is the posture of the petitioner-taxpayers here, but even amounts indisputably received by a taxpayer but from which he could derive no benefit. See, e.g., *Gilbert* v. *Comm'r*, 552 F.2d 478 (2d Cir. 1977), *rev'g* 35 T.C.M. 451 (1976); *United States* v. *Merrill*, 211 F.2d 297 (9th Cir. 1954). This rule applies as well to partners in a partnership who renounce income of the partnership for the year of renunciation. *Bishop* v. *Comm'r*, 25 T.C. 969 (1956).[9]

9. In *Bishop*, the partners of two partnerships agreed on the last day of the partnership's taxable year that the income derived by the partnerships during such taxable year belonged to a related corporation. The Tax Court held that such income was not taxable to these partners, noting (25 T.C. at 975): "In effect, the partners who received the income lost their claim to it in the year of receipt." While the constitutional issue was not expressly articulated in *Bishop*, which preceded *Glenshaw Glass* and *James*, the underlying rationale is that it is improper to tax the partner who cannot receive the benefit sought to be taxed.

Here, since the petitioner-taxpayers had no rights against the partnership to obtain any partnership income of any sort following their withdrawal, including the income which the partnership agreed with the Commissioner to create in this case some six years after their withdrawal, they could hardly be said to have realized "undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion", or pecuniary gain with "realizable economic value", as this Court requires as a constitutional prerequisite to the imposition of tax. Indeed, not only did the petitioner-taxpayers obtain no accession to their wealth, but taken as a whole, they indisputably sustained an economic loss upon their withdrawal from the partnership.

In *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), where a taxpayer sustained a loss on a transaction as a whole, this Court rejected the effort of the Commissioner to isolate one segment of the transaction and impute gain to the taxpayer on that one segment. In this case, the Commissioner's argument that the tax liabilities asserted against the Taxpayers represent "income" to them completely disregards the fact that the Taxpayers sustained the economic detriment of these losses on their transactions with the partnership taken as a whole; to isolate the disallowance of the 1966-1967 partnership deductions and assess income against the Taxpayers based thereon is directly contrary to this Court's holding in the *Kerbaugh-Empire Co.* case.

C. The Increase in Partnership Income Determined to Exist After the Withdrawal of Petitioners from the Partnership Was Allocable and Taxable Only to the Remaining Partners of the Partnership.

It is clear that partners may allocate tax liabilities among themselves, and such allocation must be upheld if it reflects economic reality and serves the business purpose of the parties. Code Section 704(b), Treas. Reg. §1.704-1(b)(2); *Harris* v. *Comm'r,* 61 T.C. 770 (1974). The inequitable result urged by the Commissioner here fails to take into account the arms'-length bargain which was struck between the partners and articulated in the partnership agreement. The express terms of the partnership agreement freeze a partner's account as of the date of his withdrawal and charge his account with the economic detriment of all losses accrued as of that date. Conversely, all economic gains (such as a tax refund) and all economic losses (such as a tax liability) following the withdrawal of the partner were properly creditable or chargeable only to the remaining members of the partnership.

Quite clearly, the partnership agreement does not contemplate charging the withdrawing partner a second time with the economic detriment of additional income tax liabilities attributable to such losses, and especially where such tax liabilities are first assessed years subsequent to that partner's withdrawal from the partnership, when that partner is unable to obtain any adjustment from the partnership.

The Commissioner's refusal to adhere for tax purposes to the partnership's own allocation produces a dreadfully

harsh result to the Taxpayers. On the one hand, they obviously sustained an economic detriment resulting from their capital accounts having been charged with the partnership's expenses and losses incurred while they were partners. On the other hand, the disallowance as deductions of the expenses and losses reflected in their reduced capital accounts results in alleged gain on which the Taxpayers must bear a second economic detriment: taxation. To compound this injustice, the economic benefit resulting from the allocable share of the tax deduction of the conversion error loss attributable to the Taxpayer's economic detriment is awarded by the Commissioner to the remaining partners of the partnership for the year 1968, and the petitioners are excluded from it.

Clearly, if the Commissioner prevails in this case, the remaining members of the partnership will have been awarded a windfall profit, inasmuch as they will have never sustained the economic losses but will have reaped the economic gain associated with the expenses and losses of the partnership previously absorbed by the petitioners and disallowed as deductions some six years later by the Commissioner. On the other hand, the petitioners will bear a tax on "income" allocated to others by the partnership agreement.

This inequitable result is clearly contrary to the decision of this Court in *United States* v. *Basye,* 410 U.S. 441 (1973). In *Basye,* a partnership comprised of physicians agreed to supply medical services for member families of a non-profit organization. In return for those services, the latter organization agreed to pay a fee, comprised, in part,

of contributions to a trust which funded a retirement benefit program of the partnership.

This Court upheld the taxation to the partners of the payment on behalf of the partners to the retirement program, notwithstanding the fact that such payments were made to the trust and not directly to the partners. The Court held that since such payments reflected compensation attributable to the services of the partnership, the partners must be taxed on such payments in accordance with their distributive share of partnership income for "[f]ew principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share." *Id.* at 454.

The *Bayse* case, therefore, requires the payment of taxes on a partner's "distributive share" of partnership income; here, the Commissioner seeks to tax "income", neither actually nor constructively distributable to a partner, but allocated by agreement to the remaining partners in the partnership. The Commissioner seeks to exact taxes where the former partner could realize no economic benefit to any extent from such income and indeed suffered an economic detriment attributable thereto.

In fact, therefore, the *Basye* decision, which upholds the Commissioner's right to tax a partner only on his distributive share of a partnership benefit, is consistent with the exclusion of this income to the Taxpayers and fundamentally inconsistent with the Commissioner's position, which would tax a partner on income to which he has no right and from which he can never realize any benefit.

POINT II

Even Assuming That the Taxpayers Must Be Charged with Income, They Are Entitled to an Offsetting Ordinary Loss Deduction Equal to Such Income to Reflect Their Inability to Receive Such Income.

Even assuming *arguendo* that the petitioner-taxpayers must be taxed on the income asserted to be theirs for the taxable years in issue, they must be allowed an offsetting ordinary loss deduction in an equivalent amount, inasmuch as such "income" is unavailable to them under the terms of the partnership agreement, and represents an outright economic loss.

In numerous prior instances, under circumstances where a taxpayer was not entitled to, or had forfeited, income on which he was taxed in a business context, the Commissioner has allowed such a taxpayer an offsetting deduction equivalent to the unobtainable income. In any objective sense, the petitioners, who are being taxed on "income" allegedly theirs, but which they can never obtain, are in a position identical to a taxpayer who forfeits accrued interest on a time savings account (deduction allowed),[10] or to a taxpayer who realizes insider profits but must disgorge such profits (deduction allowed),[11] or to a taxpayer who individually earns outside income but must pay over such income by agreement to his partnership (deduction allowed).[12]

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10. Rev. Rul. 73-511, 1973-2 Cum. Bull. 402.

11. Rev. Rul. 61-115, 1961-1 Cum. Bull. 46.

12. Rev. Rul. 64-90, 1964-1 (Part 1) Cum. Bull. 226 (1954 Code); Rev. Rul. 54-167, 1954-1 Cum. Bull. 152 and I.T. 3824, 1946-2 Cum. Bull. 37 (1939 Code).

In the context of Subchapter K of the Code, dealing with the taxation of partnerships and partners, the Commissioner has applied these principles to allow an offsetting deduction to a partner who could not obtain an amount on which he was taxed. In Rev. Rul. 64-90, 1964-1 (Part 1) Cum. Bull. 226, a partner in an equal three-man partnership received $10,000 in November 1960. The partner was required to transfer such amount to the partnership, which had other income of $8,000 for its taxable year ending January 31, 1961. Accordingly, the partnership had pooled income of $18,000, of which the partner's one-third distributive share amounted to $6,000. On these facts, the ruling held that while the partner was taxable on the $10,000 he received in calendar year 1960, he was entitled to a $4,000 loss with respect to the partnership year ended January 31, 1961, based on the difference between the amount of income he was taxed on but had transferred to the partnership and the amount of the income which he was entitled to receive from the partnership.[13]

The conclusions of Rev. Rul. 64-90 were reaffirmed and in fact extended by the Commissioner as recently as December 15, 1980 in Rev. Rul. 80-338, I.R.B. 1980-50, —. In that ruling, the Commissioner excluded from an individual partner's income amounts which he earned in his individual capacity, but was required to turn over to his partnership in accordance with the express terms of the partnership agreement.

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13. Rev. Rul. 64-90 amplified I.T. 3824, 1946-2 Cum. Bull. 37, and Rev. Rul. 54-167, 1954-1 Cum. Bull. 152, to indicate the effect of the use of a partnership fiscal year different from a partner's taxable year. Both prior published rulings had reached the identical conclusion under prior law with respect to the principles discussed herein.

Clearly, this conclusion is a fair one, since it precludes the imposition of tax upon an individual partner with respect to amounts from which he can derive no benefit. However, this is precisely the position in which the petitioners have been placed by the Commissioner, who refuses to extend to them the benefit of its own rulings.

Instead, respondent seeks to impose income tax liability with respect to retroactively created income that is completely unavailable to the petitioner-taxpayers, from which they have not, cannot and will not derive any benefit, and that results from transactions in which they suffered economic losses. At the same time, respondent seeks to deny them the benefit of any offsetting deduction to reflect their true economic posture and the unavailability of such income under any circumstances to the Taxpayers. The result for which the Commissioner contends is not only illogical and unjust, but also without any basis in the tax law.

Conclusion

For these reasons, a writ of certiorari should issue to review the judgment of the Second Circuit.

Respectfully submitted,

Elliot I. Miller
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(212) 980-0880

APPENDIX

EXHIBIT A

Memorandum Findings of Fact, Opinion and Order of the United States Tax Court

T.C. Memo. 1979-500

UNITED STATES TAX COURT

BERNARD E. TEICHGRAEBER, ET AL.,[1]

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket Nos. 7591-74, 7592-74, 7593-74, 7594-74 Filed December 13, 1979.

Elliot Ira Miller, for the petitioners.

Richard S. Kestenbaum and *Peter Matwiczyk,* for the respondent.

1. Cases of the following petitioners have been consolidated herewith: Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors, docket No. 7592-74; Bernard E. Teichgraeber and Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors, docket No. 7593-74; Richard F. Teichgraeber and Winifred M. Teichgraeber, docket No. 7594-74.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, *Judge:* Respondent determined the following deficiencies in, and additions to, the petitioners' Federal income taxes:

Petitioner	*Taxable Year*	*Deficiency*	*Addition to Tax Sec. 6652(a)*[2]
Bernard E. Teichgraeber	1967	$28,488.78[a]	—
Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors	(Yr. ending 9/30/67)	271.70	—
Bernard E. Teichgraeber and Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors	(Yr. ending 12/31/66)	9,260.10	—
Richard F. Teichgraeber and Winifred Teichgraeber	1966	12,231.08	—
	1967	47,159.13	$20

a $18,693.78 of the $28,488.78 asserted deficiency remains in dispute.

The single issue for decision is whether respondent could properly increase petitioners' taxable incomes for 1967 by disallowing a "conversion error loss" deduction of petitioners' partnership.

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2. All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue, unless otherwise specified.

Findings of Fact

Some of the facts have been stipulated. The stipulation of facts together with attached exhibits are incorporated herein by reference.

Petitioner Bernard E. Teichgraeber (hereinafter referred to as Bernard) maintained his legal residence in Greenwich, Connecticut at the time his petition in this case was filed (dkt. No. 7591-74). Petitioner filed his individual Federal income tax return for the taxable year 1967 on November 21, 1968. The record does not indicate where his return was filed.

Bernard and Barbara G. Teichgraeber were husband and wife. Barbara G. Teichgraeber died on October 14, 1966. For the fiscal period commencing October 14, 1966, and ending on September 30, 1967, the Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors, filed a fiduciary Federal income tax return with the District Director of Internal Revenue, New York, New York.

For the taxable year 1966 Bernard E. Teichgraeber and the Estate of Barbara G. Teichgraeber, deceased, Bernard E. Teichgraeber and Richard F. Teichgraeber, Executors, filed an amended joint Federal income tax return with the District Director of Internal Revenue, New York, New York.

Richard F. Teichgraeber and Winifred M. Teichgraeber were husband and wife for the taxable years at issue. For the taxable years 1966 and 1967, they filed their joint Federal income tax returns with the District Director of Internal Revenue, New York, New York (dkt. No. 7594-74).

During the calendar year 1966 and until April 27, 1967, petitioner Bernard Teichgraeber was a general partner in

the partnership of Thomson & McKinnon (hereinafter the partnership). Petitioner Richard Teichgraeber, father of Bernard, was a general partner in the partnership during 1966 and 1967 until December 31, 1967. Bernard's late wife, Barbara, was a limited partner in the partnership in 1966 until her death on October 14, 1966. Bernard's capital account with the partnership (initial contribution) was $160,000, Richard's was $304,000, and Barbara's was $75,000. The partnership was in the business of brokerage and purchase and sale on commission of securities and commodities.

Upon terminating his partnership interest in April 1967, Bernard entered into a "subordinated cash loan agreement" with the partnership whereby his partnership interest was converted into a subordinated debt of the partnership.[3] Bernard demanded repayment of the subordinated loan on October 3, 1967. Ultimately, on or about November 24, 1967, Bernard instituted arbitration proceedings before the New York Stock Exchange, and on or about July 8, 1968, an award was issued by the arbitrators.

Pursuant to the award, the partnership paid Bernard $167,493.33, which represented a return of Bernard's capital amount plus interest which had accrued during the period of the subordinated cash loan agreement. The arbitration award stated that:

> It is also hereby decided and determined that this award is in no way intended to preclude the respond-

3. Although usual circumstances may have warranted a liquidating distribution, at that time the partnership was unable to make such a distribution because of capital requirements established by the New York Stock Exchange.

> ents (sic) [the partnership's] recovery from claimant [Bernard], of the proportionate share of any losses for which the claimant would be responsible as a former general partner of Thomson & McKinnon [the partnership] in accordance with his partnership agreement.

Accordingly, after the arbitration award, Bernard paid $74,576.47 to the partnership, representing his then-determined pro-rata share of the partnership losses.

Only Bernard Teichgraeber (dkt. No. 7591-74) participated in an arbitration agreement with the partnership to determine the value of his interest after retiring from the partnership. The accounts of the remaining petitioners were settled with the partnership without recourse to arbitration.

Respondent subsequently determined that the following items were improperly reported on the partnership return for the periods ending December 31, 1966, and December 31, 1967:

	1966	*1967*
Interest expense incurred to carry tax exempt bonds	$145,143.74	$ 97,431.40
Bad debts	462,322.23	97,412.39
Travel and entertainment expense	25,780.86	33,679.35
Conversion errors		1,343,740.00

Accordingly, respondent issued deficiency notices to petitioners herein, in which he explained the adjustments made in the partnership's returns for the taxable years 1966 and 1967, and increased petitioners' taxable incomes to reflect their shares of the partnership income for those years.[4]

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4. At trial and on brief, petitioners did not address the adjustments pertaining to interest expense, bad debts, and travel and entertainment expenses. Instead, as explained *infra*, they focused their attention on the conversion error losses, contending this adjustment created "phantom income" that cannot constitutionally be taxed to them.

Initially, the Service proposed to disallow the $1,343,740 deduction for conversion errors, claimed by the partnership on its 1967 return, in its entirety. However, the Service later agreed to accept the full amount of the conversion account disallowance, not in 1967, as originally claimed, but in 1968.

Thus, all of the partnership members were assessed deficiencies for 1966 and 1967, based (in part) on the partnership's disallowed 1967 "conversion error loss" deduction of approximately $1.3 million, which thereby increased each partner's taxable income for that year by his pro rata share in the partnership.

However, in regard to the roll-over of the conversion error loss to the partnership from 1967 to 1968, the partnership noted in a 1973 letter to the partners from the partnership executive committee, that this delayed deduction would be beneficial to its 1968 members, because the partnership had a higher taxable income in 1968, so that most partners probably were in higher tax brackets, and also because of the 7½ percent tax surcharge applicable in 1968. Thus, the letter stated, the deduction in 1968 would be worth substantially more to them, in total, than the same deduction in 1967.

Opinion

Petitioner, Bernard Teichgraeber, was a general partner of Thomson and McKinnon during 1966 and through April 27, 1967. During the period commencing January 1, 1966 and ending at her death on October 14, 1966, Bernard's late wife, Barbara, was a limited partner in the partnership. During 1966 and 1967, petitioner Richard Teichgraeber was also a general partner of Thomson and McKinnon. Thom-

son and McKinnon was in the business of brokerage and purchase and sale on commission of securities and commodities for customers. Pursuant to the partnership agreement, net operating profits and losses were charged against the capital accounts of the individual partners in accordance with percentages established in the partnership agreement.

When the partnership converted its bookkeeping system from an in-house system to a computerized system maintained by an independent organization, certain "conversion error losses" were incurred. The "conversion error losses" were caused by mistakes in recording the purchase or sale of securities by the brokers, such as, for example, recording the wrong security, or recording the wrong broker. These errors caused "differences" and were researched by a "difference crew." After a certain amount of time, these differences were transferred into a "difference account" for further research. It was in relation to these differences that the ultimate corrective sales and purchases took place. Apparently, what could not be recovered or straightened out by sale was marked by the partnership as a "conversion error loss."

In June 1968, the partnership decided to take a deduction for these conversion error losses against 1967 income. At that time the capital accounts of each partner were reduced accordingly. In notices of deficiencies subsequently issued, respondent determined that the conversion error losses did not occur in 1967, and petitioners' distributive shares of the partnership net income for 1967 were therefore increased.

It is respondent's position that the conversion error loss was properly allowable in 1968, when petitioners were no

longer partners. Thus, although the amounts received by petitioners on their withdrawal from the partnership were computed as though the conversion error losses occurred in 1967, the respondent has disallowed the loss in that year and allowed it in 1968. Since petitioners were not partners in 1968 they were unable to take advantage of the loss and claim any part of the deduction. The net effect is that petitioners' capital accounts were computed on withdrawal from the partnership to reflect conversion error losses as occurring in 1967 while the respondent contends that the loss was allowable to the partnership in 1968.

In our Memorandum Sur Order of March 2, 1976, we succinctly stated for the benefit of both parties the issue presented by these facts:

> The key question in this case is the year in which all events fixed the fact of a loss to the partnership. The determination as to the year of a loss is made by examining all the facts and circumstances. If, upon trial, the Court should find that the loss occurred in 1967, petitioners will prevail. However, if the loss is found to have occurred in 1968, petitioners will be liable for the deficiencies since they were no longer partners in 1968, and thus would not be entitled to deduct any loss in that year.[5]

5. There have been numerous hearings in this case and at nearly every point it has been made clear to the petitioners that this was the central issue in the case. Petitioners filed a motion for an order to produce documents in the cases herein, pursuant to Rule 70, Tax Court Rules of Practice and Procedure on January 17, 1975 (relating to a Technical Advice Memorandum by respondent). After a hearing, on February 26, 1975, such motion was denied. See *Teichgraeber* v. *Commissioner*, 64 T.C. 453 (1975).

Petitioners subsequently filed a motion for summary judgment, pursuant to Rule 121, Tax Court Rules of Practice and Procedure,

(footnote continued on next page)

Focusing on the year of loss, it is well-established that the question of the year in which a loss is sustained is one of fact. See *C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F.2d 57 (3d Cir. 1955), revg. 22 T.C. 124 (1954); *Coors Porcelain Co.* v. *Commissioner*, 52 T.C. 682 (1969), affd. 429 F.2d 1 (10th Cir. 1970) (involving an alleged loss resulting from a bookkeeping error made in a prior year). For the allowance of a loss deduction, the hornbook law is that "the loss must be one sustained in a *closed transaction* during the taxable year." [Emphasis added.] [5 Mertens, Law of Federal Income Taxation, sec. 28.04, p. 10 (1957 rev.).] See also Sec. 1.165-1(b) and (d), Income Tax Regs.

The partnership herein follows a calendar-year accrual basis method of accounting. On the record before us, we find that the conversion error account was not closed, and thereby given up as a loss, for purposes of the case herein, until sometime in 1968.

First, in a letter from the partnership to its partners, including the Teichgraebers, who were affected by respondent's disallowance of the several deductions for 1966 and

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on October 23, 1975. Following a hearing on January 21, 1976, petitioners' motion was denied on March 2, 1976, by a Memorandum Sur Order which determined that there was a genuine issue of fact for trial.

Petitioners, in turn on March 10, 1976, filed a motion for reconsideration by the Court en banc or in the alternative by the Chief Judge of their motion for summary judgment and the Memorandum Sur Order dated March 2, 1976, denying such motion, pursuant to Rule 121, Tax Court Rules of Practice and Procedure. This motion was denied in both alternatives by an order dated April 2, 1976.

Petitioners had also, on March 10, 1976, filed a motion to amend and revise the Memorandum Sur Order to provide for an immediate appeal to the Circuit Court of Appeals pursuant to 28 U.S.C. sec. 1292(b) on the ground that a "controlling question of law" was involved. Such motion was denied by an order dated April 2, 1976.

1967, the executive committee of the partnership stated that:

> After more than three years of intensive negotiations, the IRS has agreed to accept the $1,343,740 of the conversion account disallowance as a proper deduction in full, however, not in 1967 as originally claimed, but in 1968 (*which was the year of the ultimate write-off*). [Emphasis added.]

In addition, petitioner Bernard Teichgraeber, in his affidavit in support of the petitioners' motion for summary judgment, after stating that he has personal knowledge of all the facts and circumstances therein contained, states, in explaining how the conversion errors (referred to here as the "difference account") were handled:

> On or about July 28, 1967 the annual surprise audit required by the New York Stock Exchange and the Securities and Exchange Commission was conducted of the Partnership's books and records by an independent certified public accounting firm. As a result of that audit the New York Stock Exchange was informed that the Partnership's difference account amounted to a net deficit of approximately $2,064,000.00.
>
> Steps were taken to reduce * * * the difference account deficit. As of the end of 1967, the net debit differences were reduced to $1,343,740.00. *In June of 1968, the Partnership made the decision* that it had done everything possible to correct the errors and that it should accrue the deduction against 1967 income via amendment to the 1967 Partnership return. At that time the capital accounts of each partner, including that amount of the capital account withheld from my father when he withdrew, were reduced accordingly. I paid my pro rata share of these losses in accordance with the arbitration decision. * * * [Emphasis added.]

Finally, Joseph F. Marino, controller of the partnership beginning in May 1968 (when the books and records concerning conversion error losses were still being straightened out) testified as follows on this question:

> [Counsel for Respondent] * * * It was on that [partnership's 1967] Return that the conversion loss was deducted. When did the majority of the sales and purchases of the securities represented in the difference account take place?
>
> [Mr. Marino] *July and August of 1968, were our clean up months.* [Emphasis added.]

Thus, for purposes of the case herein, we find that the conversion error losses should properly have been taken as a deduction by the partnership in 1968 rather than 1967.

Petitioners have not addressed the issue of whether 1967 or 1968 was the proper year of the loss. Rather petitioners at trial took the position that "the correct year of the loss * * * is irrelevant to the correctness of trying to tax the petitioners on an income they never got and never could get."

This is simply not the law, for it is clear under the law of partnership taxation that the petitioners did receive income from the partnership. As the Supreme Court has succinctly stated:

> Section 703 of the Internal Revenue Code of 1954, insofar as pertinent here, prescribes that "[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual." 26 U.S.C. § 703(a). Thus, while the partnership itself pays no taxes, 26 U.S.C. § 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partner-

> ship is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed. [*United States* v. *Basye*, 410 U.S. 441, 448 (1973). (Fn. ref. omitted).]

The tax provisions governing this case are fundamental and based upon common notions of partnership law. Section 701 provides that it is each individual partner and not the partnership that is subject to tax. Section 702 provides that each partner must take into account his or her distributive shares of the partnership's net income. Section 704(a) provides that a partner's distributive share of partnership income shall be determined by the partnership agreement.

The partnership agreement in effect in 1967 provided that net operating losses were chargeable to each partner's capital account in a specified percentage. Accordingly, the partnership's disallowed deductions for the taxable year 1967 become taxable income to each partner, *pro rata*, who was a member of the partnership during that year. It is clear that an item will be net income to a partner whether or not a distribution is actually made. See 6 Mertens, Law of Federal Income Taxation, sec. 35.22 p. 70 (1975 rev.). As the Supreme Court also clearly stated in *Bayse*, "Few principles of partnership taxation are more firmly established than this one that no matter the reason for nondistribution each partner must pay taxes on his distributive share." *United States* v. *Basye*, 410 U.S. 441, 454 (1973). [Citations omitted.] The disallowance of the conversion errors loss affected the members of the partnership as of

1967 only. The allowance of that item as a deduction in 1968 affected the partners of that year only. This follows from application of the rules of partnership taxation to the facts before us.

Petitioners nevertheless advance three arguments. First, they contend that they did not receive any economic benefit from the increase in partnership income for 1967 occurring by reason of the reduction of the partnership's deductions for that year, and that to charge them with such "phantom income" would violate the Sixteenth Amendment to the Constitution of the United States and established principles of law holding that income includes only accessions to wealth and readily ascertainable economic gains. Second, petitioners assert that if the Commissioner's position is sustained, an offsetting deduction should be allowed to petitioners to take into account for tax purposes the adverse economic impact suffered by them when their capital accounts were charged with the conversion error losses in 1967. Third, petitioners contend that fairness and equity in the tax laws precludes the imposition of taxes on "phantom income" which petitioners never received or could receive.

Aside from dicta in *James* v. *United States,* 366 U.S. 213 (1960), and *Commissioner* v. *Glenshaw Glass Co.,* 348 U.S. 426 (1955) (observing that income may be constitutionally taxed only when there is a gain with readily realizable economic value or an undeniable accession to wealth, clearly realized), petitioners' constitutional argument rests on *Bowers* v. *Kerbaugh-Empire Co.,* 271 U.S. 170 (1926), and *Conner* v. *United States,* 439 F.2d 974 (5th Cir. 1971), both of them inapposite to the facts before us. In *Kerbaugh-Empire* the Supreme Court held that the difference

between marks borrowed and marks paid back on a loan integrally related to a business venture was not income because the entire venture resulted in a substantial loss. The Court observed that "The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income." 271 U.S. at 175. *Conner* v. *United States, supra* which was primarily concerned with the question of how to compute the amount of a casualty loss to a dwelling, is not analogous to the facts before us.

Petitioners contend *United States* v. *Basye, supra* is authority for providing them with a deduction for the portion of their capital accounts retained by the partnership to cover the conversion error loss. Petitioners argue that the district court opinion, *Basye* v. *United States*, 295 F. Supp. 1289 (N.D. Cal. 1968), noted that the *Service* there proposed to allow a partner who forfeited her rights to deferred compensation "an ordinary loss deduction which would offset the assessment of trust income made against her." *Basye* at 295 F. Supp. 1289, 1292. On this basis, petitioners argue that they should be allowed an offsetting ordinary loss deduction for 1967 to compensate for the economic loss sustained by them in that year when, as to them, the economic impact of the transaction was irrevocably sustained. However, *Basye* v. *United States, supra* dealt with whether an item was *currently* taxable as income to a *partnership* at a given time. In addition, in *United States* v. *Basye,* 410 U.S. 441 (1973), the Supreme Court, following a long line of legislative history and commentary, reiterated the concept of the partnership as the tax reporting entity, and the partner as the tax paying entity, for the purpose of passing along the taxable-as-income char-

acter or the deductible-as-expense character of a particular item. *United States* v. *Basye, supra* at 448. See also *Moore* v. *Commissioner,* 70 T.C. 1024, 1029 (1978), and *Frankel* v. *Commissioner,* 61 T.C. 343, 349 (1973), affd. 506 F.2d 1051 (3d Cir. 1974). We see no basis for providing petitioners with the loss deduction they claim.

Finally, petitioners' argument that fairness and equity requires them to prevail must also fail. If they have been treated unfairly, it is by the partnership in connection with their withdrawal. As respondent points out, petitioners' position would mean that the Government is bound by the partnership information return in the case of a partner who was a member of the partnership in one year but not in a subsequent year. Petitioners are really arguing that under the circumstances before us, a retiring partner's liability is fixed as of the date he withdraws from the partnership, and the Government may not make an adjustment as to the proper year of deduction in any subsequent audit. This is clearly not the law, and indeed, as to the items other than the conversion error loss involved in the adjustments before us (interest expenses, bad debts, and travel and entertainment expenses) petitioners do not really contend that the adjustments were improper. We believe that any grievance petitioners have about the inadequacy of the amounts received on the settlements of their capital accounts was properly with the partnership.

Though the result may be unfortunate for petitioners, it is clear that under the terms of the partnership agreement, and according to well-established principles of partnership taxation, petitioners realized an increase in taxable income from the partnership based on the disallowed

partnership deductions for the taxable years (1966 and 1967) during which they were members of the partnership. Due to concessions,

Decision will be entered under Rule 155 in dkt. No. 7591-74.

Decisions will be entered for respondent in dkt. Nos. 7592-74 7593-74 and 7594-74.

UNITED STATES TAX COURT

WASHINGTON

Docket No. 7591-74, 7592-74,
7593-74, 7594-74

BERNARD E. TEICHGRAEBER, ET AL.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ORDER

For cause, it is

ORDERED: That the Court's Memorandum Findings of Fact and Opinion filed December 13, 1979 (T.C. Memo. 1979-500) is hereby amended as follows:

On page 19, last two words on line 15 and line 16 "Due to concessions," should be eliminated and on page 19, lines 17 through 21, "Decision will be entered under Rule 155 in dkt. No. 7591-74" and Decisions will be entered for respondent in dkt. Nos. 7592-74, 7593-74 and 7594-74" should be deleted and "Decisions will be entered for the respondent" should be substituted therefor.

/s/ RICHARD C. WILBUR
Judge

Dated: December 14, 1979
Washington, D.C.

EXHIBIT B

Decisions of the United States Tax Court

UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

Docket No. 7591-74

BERNARD E. TEICHGRAEBER

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Memorandum Findings of Fact and Opinion filed December 13, 1979, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1967 in the amount of $28,488.78.

/s/ RICHARD C. WILBUR
Judge

Entered: December 20, 1979

UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

Docket No. 7592-74

ESTATE OF BARBARA G. TEICHGRAEBER, DECEASED, BERNARD E. TEICHGRAEBER AND RICHARD F. TEICHGRAEBER, EXECUTORS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Memorandum Findings of Fact and Opinion filed December 13, 1979, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year ended September 30, 1967 in the amount of $271.70.

/s/ RICHARD C. WILBUR
Judge

Entered: December 20, 1979

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 7593-74

BERNARD E. TEICHGRAEBER AND ESTATE OF BARBARA G. TEICHGRAEBER, DECEASED, BERNARD E. TEICHGRAEBER AND RICHARD F. TEICHGRAEBER, EXECUTORS,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Memorandum Findings of Fact and Opinion filed December 13, 1979, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year ended December 31, 1966 in the amount of $9,260.10.

/s/ RICHARD C. WILBUR
Judge

Entered: December 20, 1979

UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

Docket No. 7594-74

RICHARD F. TEICHGRAEBER and WINIFRED M. TEICHGRAEBER,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its Memorandum Findings of Fact and Opinion filed December 13, 1979, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioners for the taxable years 1966 and 1967 in the amounts of $12,231.08 and $47,159.13, respectively, and there is an addition to the tax due from the petitioners under section 6652(a), Internal Revenue Code of 1954, for the taxable year 1967 in the amount of $20.00.

/s/ RICHARD C. WILBUR
Judge

Entered: December 20, 1979

EXHIBIT C

Judgment of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

N.B. Since this statement does not constitute a formal opinion of this court and is not uniformly available to all parties, it shall not be reported, cited or otherwise used in unrelated cases before this or any other court.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 7 day of October one thousand nine hundred eighty.

Present: Hon. William H. Mulligan
Hon. William H. Timbers
Hon. Edmund L. Palmieri*
Circuit Judges,

80-4053

BERNARD E. TEICHGRAEBER: ESTATE OF BARBARA G. TEICHGRAEBER, Deceased, BERNARD E. TEICHGRAEBER and RICHARD F. TEICHGRAEBER, EXECUTORS: BERNARD E. TEICHGRAEBER and ESTATE OF BARBARA G. TEICHGRAEBER, DECEASED, BERNARD E. TEICHGRAEBER and RICHARD F. TEICHGRAEBER, EXECUTORS: RICHARD F. TEICHGRAEBER and WINIFRED M. TEICHGRAEBER,

Appellants,

against

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Appeal from the United States Tax Court.

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* United States District Judge for the Southern District of New York sitting by designation.

This cause came on to be heard on the transcript of record from the United States Tax Court, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said Tax Court be and it hereby is affirmed on the opinion below of the Hon. Richard C. Wilbur, T.C. Memo. 1979-500, 39 T.C.M. 710 (U.S.T.C. December 13, 1979).

/s/ William H. Mulligan

William H. Mulligan

/s/ William H. Timbers

William H. Timbers

/s/ Edmund L. Palmieri

Edmund L. Palmieri

EXHIBIT D

Text of Constitutional, Statutory and Regulatory Provisions Involved

28 U.S.C. § 1254. Courts of Appeals; Certiorari; Appeal; Certified Questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

UNITED STATES CONSTITUTION

Amendment V—Capital Crimes; Double Jeopardy; Self-Incrimination; Due Process; Just Compensation for Property

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

UNITED STATES CONSTITUTION

Amendment XVI—Income Tax

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INTERNAL REVENUE CODE

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

[Sec. 704(a)]

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

[Sec. 704(b)]

(b) DETERMINATION OF DISTRIBUTIVE SHARE.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

NEW YORK CIVIL PRACTICE LAW AND RULES

§ 213. Actions to Be Commenced Within Six Years; Where Not Otherwise Provided for; On Contract; On Sealed Instrument; On Bond or Note, and Mortgage Upon Real Property; By State Based on Misappropriation of Public Property; Based on Mistake; To Establish a Will; By Corporation Against Director, Officer or Stockholder; Based on Fraud

The following actions must be commenced within six years:

2. an action upon a contractual obligation or liability express or implied, except as provided in article 2 of the uniform commercial code;

§ 7501. Effect of Arbitration Agreement

A written agreement to submit any controversy thereafter arising or any existing controversy to arbitration is enforceable without regard to the justiciable character of the controversy and confers jurisdiction on the courts of the state to enforce it and to enter judgment on an award. In determining any matter arising under this article, the court shall not consider whether the claim with respect to which arbitration is sought is tenable, or otherwise pass upon the merits of the dispute.

TAX REFORM ACT OF 1976

SEC. 213. CERTAIN PARTNERSHIP PROVISIONS

(a) DOLLAR LIMITATION WITH RESPECT TO ADDITIONAL FIRST-YEAR DEPRECIATION ALLOWANCE.—Subsection (d) of section 179 (relating to additional first-year depreciation allowance for small business) is amended by redesignating paragraph (8) as paragraph (9) and by inserting after paragraph (7) the following new paragraph:

"(8) DOLLAR LIMITATION IN CASE OF PARTNERSHIPS.—In the case of a partnership, the dollar limitation contained in the first sentence of subsection (b) shall apply with respect to the partnership and with respect to each partner."

(b) CLARIFICATION OF TREATMENT OF PARTNERSHIP SYNDICATION FEES, ETC.—

(1) IN GENERAL.—Part I of subchapter K of chapter 1 (relating to determination of tax liability) is amended by adding at the end thereof the following new section:

"SEC. 709. TREATMENT OF ORGANIZATION AND SYNDICATION FEES.

"(a) GENERAL RULE.—Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

"(b) AMORTIZATION OF ORGANIZATION FEES.—

"(1) DEDUCTION.—Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations pre-

scribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

"(2) ORGANIZATIONAL EXPENSES DEFINED.—The organizational expenses to which paragraph (1) applies, are expenditures which—

"(A) are incident to the creation of the partnership;

"(B) are chargeable to capital account; and

"(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life."

(2) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following:

"Sec. 709. Treatment of organization and syndication fees."

(3) DETERMINATION OF AMOUNTS CHARGEABLE TO CAPITAL ACCOUNT.—Section 707(c) (relating to guaranteed payments) is amended by striking out "and section 162(a)" and inserting in lieu thereof "and, subject to section 263, for purposes of section 162(a)".

(c) ITEMS MUST BE ALLOCATED TO PORTION OF YEAR PARTNER HELD INTEREST.—

(1) IN GENERAL.—Subparagraph (B) of section 706(c)(2) (relating to disposition of less than entire interest) is amended by striking out "or with respect to a partner whose interest is reduced" and inserting in lieu thereof "or with respect to a partner whose interest is reduced (whether by entry of a new partner,

partial liquidation of a partner's interest, gift, or otherwise)".

(2) CERTAIN PROVISIONS OF SUBCHAPTER K MAY NOT BE OVERRIDDEN BY PARTNERSHIP AGREEMENT.—Subsection (a) of section 704 (relating to effect of partnership agreement) is amended by striking out "except as otherwise provided in this section" and inserting in lieu thereof "except as otherwise provided in this chapter".

(3) CROSS REFERENCES.—

(A) Seciton 704 is amended by adding at the end thereof the following:

"(f) CROSS REFERENCE.—

"For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see section 706(c)(2)."

(B) Section 761 (relating to terms defined) is amended by adding at the end thereof the following:

"(e) CROSS REFERENCE.—

"For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see sections 704(b) and 706(c)(2)."

(d) DETERMINATION OF PARTNER'S DISTRIBUTIVE SHARE.—Subsection (b) of section 704 (relating to distributive share determined by income or loss ratio) is amended to read as follows:

"(b) DETERMINATION OF DISTRIBUTIVE SHARE.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

"(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

"(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect."

(e) TREATMENT OF PARTNERSHIP LIABILITIES WITH RESPECT TO WHICH THE PARTNER IS NOT PERSONALLY LIABLE.—Section 704(d) (relating to limitation on allowance of losses) is amended by adding at the end thereof the following new sentences:

"For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability. The preceding sentence shall not apply with respect to any activity to the extent that section 465 (relating to limiting deductions to amounts at risk in case of certain activities) applies, nor shall it apply to any partnership the principal activity of which is investing in real property (other than mineral property)."

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply in the case of partnership taxable years beginning after December 31, 1975.

(2) SUBSECTION (e).—The amendment made by subsection (e) shall apply to liabilities incurred after December 31, 1976.

(3) SECTION 709(b) OF THE CODE.—Section 709(b) of the Internal Revenue Code of 1954 (as added by the amendment made by subsection (b)(1) of this section) shall apply in the case of amounts paid or incurred in taxable years beginning after December 31, 1976.

TREASURY REGULATIONS

§ 1.704-1. Partner's distributive share.

(b) *Distributive share determined by income or loss ratio.*

(2) If the principal purpose of any provision in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership (as described in section 702(a)(9)). In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (4). KL is a brokerage partnership with assets consisting of securities with a basis of $20,000 and a value of $50,000. M makes a $25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to $74,000, they are sold. Of the $54,000 taxable gain on the sale of the securities, $24,000 (appreciation in value occurring after M became a partner) is allocated in equal shares to K, L, and M, in accordance with the ratio for sharing profits and losses generally. The $30,000 balance is allocated to K and L in the profit and loss ratio existing before M became a partner. This latter allocation attributes to K and L the appreciation in value of the securities occurring before M became a partner, even though the cash proceeds are a partnership asset in which all three partners share equally. This allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose of the allocation was tax avoidance or evasion.

INTERNAL REVENUE CODE

SEC. 6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

[Sec. 6213(a)]

(a) TIME FOR FILING PETITION AND RESTRICTION ON ASSESSMENT.—Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6851 or section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B or chapter 41, 42, 43, 44, or 45 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

No. 80-1109

In the Supreme Court of the United States

OCTOBER TERM, 1980

BERNARD E. TEICHGRAEBER, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented in this federal income tax case is whether petitioners were entitled to deduct their share of certain partnership losses and expenses, which they claimed for years when they were still members of the partnership, where such deductions were allowed, after audit, for years after their withdrawal from the partnership.

1. The pertinent facts may be summarized as follows: Until 1967, petitioners were partners in Thomson & McKinnon, a brokerage firm. One of the partners, petitioner Barbara Teichgraeber, died in October 1966. Another partner, petitioner Richard F. Teichgraeber, withdrew as of December 31, 1967. A third partner, petitioner Bernard E. Teichgraeber, terminated his partnership interest on April 27, 1967 (Pet. App. 3a-4a).[1] After each of the

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[1]Because of certain difficulties in reaching a settlement with the partnership, petitioner Bernard E. Teichgraeber submitted the matter

petitioners was no longer a member of the partnership, the Internal Revenue Service conducted an audit of partnership returns for 1966 and 1967 and determined that the following deductions claimed on those returns had been improperly reported (Pet. App. 5a):

Deduction	1966	1967
Interest expense incurred to carry tax exempt bonds	$145,143.74	$97,431.40
Bad debts	462,322.23	97,412.39
Travel and entertainment expense	25,780.86	33,679.35
Conversion errors		$1,343,740.00

The partnership eventually conceded the nondeductibility of all items except the $1,343,740 conversion error loss, which the partnership and the Commissioner agreed was deductible but should have been deducted in 1968 rather than 1967 (Pet. App. 6a).

Upon the conclusion of the agreement between the partnership and the Service, the Commissioner issued deficiency notices to all persons, including petitioners, who had been members of the partnership in 1966 and 1967, to reflect the disallowance of the individual partners' aliquot share of the disallowed partnership deductions. Petitioners' deficiencies totalled $97,410.09 plus a $20.00 addition to tax (Pet. App. 2a, 5a-6a).

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to arbitration in order to complete his withdrawal from the partnership. Pursuant to the arbitration order, the partnership paid him $85,423.53, an amount equal to his original $160,000.00 capital contribution less $74,576.47, which he paid back to the partnership in order to compensate it for certain losses (Pet. App. 4a-5a).

In this proceeding brought by petitioners for redetermination of deficiencies, the Tax Court upheld the Commissioner (Pet. App. 1a-16a). It ruled that petitioners could not deduct any portion of partnership expenses for years in which they were no longer partners. It also held that the interest and bad debt expenses reported on the partnership return were not deductible and that the conversion error loss reported on that return was properly deductible only in 1968. The court of appeals affirmed on the basis of the Tax Court's opinion (Pet. App. 22a-23a).

2. The decision below correctly upheld the Commissioner's disallowance of petitioners' claimed partnership losses and expenses. It is undisputed that the deficiencies at issue here derive entirely from the disallowance of certain deductions that had initially been claimed on the partnership return, and that were, in turn, reflected on petitioners' returns.[2] Petitioners do not contend that the Commissioner's disallowances were anything other than entirely proper. They argue (Pet. 5-6), however, that at the time they withdrew from the partnership, their capital accounts were allegedly reduced to reflect the losses which the partnership erroneously claimed as deductions in 1966 and 1967. Since the net amounts they realized upon their withdrawals may have reflected those disallowed deductions, petitioners urge that they should be allowed a deduction for the properly disallowed partnership expenses and losses.

But there is no evidence to show that petitioners' returned capital was reduced on the basis of a miscalculation of 1966 and 1967 net income. Moreover, even if their capital was so

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[2]Certain of the deductions claimed for the years at issue (1966 and 1967) were allowed by the Commissioner for 1968. Because petitioners were no longer partners in 1968, they could not claim any portion of those deductions on their 1968 returns. *Moore* v. *Commissioner*, 70 T.C. 1024, 1033-1034 (1978).

reduced, it is irrelevant to petitioners' tax liability. The partnership income taxed to them during the years in issue was properly apportioned to them under the partnership agreement. Nothing in the partnership agreement suggests that petitioners were not responsible for their share of partnership income or that the other members of the partnership agreed to have it allocated to them. Thus, this case is unlike the situation in *Harris* v. *Commissioner*, 61 T.C. 770 (1974), upon which petitioners rely (Pet. 17), where there was such an agreement.

Moreover, even assuming that petitioners are barred from ever recouping capital they might have received had the partnership's 1966 and 1967 expenses been properly reflected in their capital accounts at the time their interests were redeemed, it simply means petitioners agreed to take less capital than was due them. While that undoubtedly affected the tax reportable upon their withdrawal from the partnership, it has no bearing on their liability for taxes on their share of the 1966 and 1967 partnership income. Hence, petitioners' constitutional arguments (Pet. 11-16) have no merit. Petitioners are unquestionably responsible for income which they earned. As this Court stated in *United States* v. *Basye*, 410 U.S. 441, 447-448 (1973), "[p]artners are taxable on their distributive or proportionate shares of current partnership income irrespective of whether that income is actually distributed to them." *Heiner* v. *Mellon*, 304 U.S. 271 (1938); see Sections 702 and 704 of the Internal Revenue Code of 1954 (26 U.S.C.).[3]

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[3]Contrary to petitioners' argument (Pet. 20-21), neither Rev. Rul. 73-511, 1973-2 Cum. Bull. 402, clarified by Rev. Rul. 75-21, 1975-1 Cum. Bull. 367, nor Rev. Rul. 64-90, 1964-1 Cum. Bull. 226, has any bearing on this case. The first ruling deals with income which is earned but later forfeited. The year in which it is earned, it is taxable; the year forfeited, it is a loss. Here, however, both the 1966 and 1967 income was

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

FEBRUARY 1981

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earned, it was never lost or forfeited. Revenue Ruling 64-90, *supra*, is similarly inapposite. There, a partner received monies on behalf of both himself and his partners. The entire sum was taxable to him in his year of receipt, and he was later given a correlative loss deduction for the portion he paid over to his fellow partners. Here, all the 1966 and 1967 income has been taxed to the members of the partnership for those years.